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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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AZ CORP COMMISSION
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WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE APPLICATION OF MIDVALE TELEPHONE EXCHANGE, INC. FOR AUTHORITY TO INCREASE RATES AND FOR DISBURSEMENT FROM THE ARIZONA UNIVERSAL SERVICE FUND.

DOCKET NO. T-02532A-00-0512

STAFF'S NOTICE OF FILING

Staff of the Arizona Corporation Commission hereby files the testimony summaries of Staff witnesses Joel Reiker, Darron Carlson, Sonn Albrecht, Allen Buchalew and Richard Boyles, of the Utilities Division, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 17th day of May, 2001.

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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
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Commissioner

IN THE MATTER OF THE APPLICATION OF MIDVALE TELEPHONE EXCHANGE FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR MARKET VALUE OF THE COMPANY FOR RATE MAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH A RETURN AND TO CONSIDER THE REQUEST TO EXTEND THE COMPANY'S CERTIFICATE OF CONVENIENCE AND NECESSITY TO INCLUDE NEW SERVICE AREAS	DOCKET NO. T-02532A-00-0512

SUMMARY OF PRE-FILED TESTIMONIES

OF

DARRON W. CARLSON,
JOEL REIKER,
SONN AHLBRECHT,
AND
ALLEN G. BUCKALEW (CONSULTANT)

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

MAY 17, 2001

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DIRECT TESTIMONIES

DARRON W. CARLSON

The direct testimony of Staff witness, Darron W. Carlson, addresses the Company's operating revenues and expenses and the Company's revenue requirement. Staff recommends intrastate operating revenue of $747,819. Staff's recommended intrastate operating revenue is $17,391 more than the Test Year revenue and $275,295 less than the $1,023,114 intrastate operating revenue proposed by the Company. Staff's recommended intrastate operating revenue reflects Staff's adjustments to operating expenses, rate base, and cost of capital. Staff's primary operating revenue and expense adjustments are as follows:

<u>1. Midvale's Requested Extended Area Service ("EAS")</u>

Staff adjustments increased two revenue accounts by a total of $32,877. Staff removed Midvale's pro forma adjustments reducing these accounts due to EAS based on Staff witness, Mr. Allen G. Buckalew's recommendation to deny approval of the EAS request.

<u>2. Midvale's Requested Unserved Areas</u>

Staff's adjustments decreased six revenue accounts by a total of $143,572. Also, Staff's adjustments decreased seven expense accounts by a total of $183,992. This results from Staff's removal of all of Midvale's pro forma adjustments increasing these accounts due to its inclusion of estimated revenues and expenses expected from the new unserved areas. Staff believes the inclusion of these estimates is not appropriate in a rate case filing as they are not "known and measurable".

<u>3. Depreciation Expense</u>

Staff's adjustment increased depreciation expense by $29,690. Staff's adjustment reflects the new depreciation rates recommended by Staff witness, Mr. Richard Boyles on a going-forward basis.

4. Corporate Operations Expense

Staff's adjustment decreased corporate operations expense by $13,543. Staff's adjustment reflects Staff's belief that the Company claimed rate case expenses are excessive and include items not associated with the rate case. Staff's adjustment reflects its reasonable determination of the proper level of rate case expense.

5. Miscellaneous (Interest Expense)

Staff's adjustment decreased miscellaneous (interest expense) by $15,948. Staff's adjustment reflects Staff's belief that interest expense is a "below-the-line" expense item and should not be included in the calculation of operating income.

6. Federal and State Income Tax

Staff's adjustment increased federal and state income tax by $47,413. Staff's adjustment was necessary because Midvale failed to claim any income tax liability, an operating expense. Staff calculated Test Year income tax based on the adjusted jurisdictional revenues and expenses.

JOEL M. REIKER

Staff recommends a capital structure consisting of 22.60 percent long-term debt and 77.40 percent common equity.

Staff recommends a cost of long-term debt of 5.47 percent.

Staff recommends an 11.50 percent cost of equity capital. The 11.50 percent figure is based on the results of Staff's cost of equity analysis, which used both the DCF and CAPM methodologies.

Based on the results of Staff's capital structure, cost of equity, and debt analyses, Staff recommends a 10.14 percent cost of capital for Midvale. This figure represents the weighted cost of both the Company's debt and common equity.

SONN AHLBRECHT

The testimony of Staff witness, Sonn S. Ahlbrecht, addresses Midvale's rate base. Staff recommends an intrastate rate base of $1,244,841, or $562,255 less than the $1,807,096 rate base proposed by the Company. Staff made five adjustments to the Company's proposed rate base as described below.

Staff's first adjustment consisted of reclassification of $5,619 in public telephone equipment. Due to deregulation of public telephones, it is not appropriate to recover the cost of those assets through regulated rates.

The second adjustment removed proforma plant in the amount of $1,087,603 related to unserved areas proposed in Midvale's application. Proforma plant does not meet the criteria of "known and measurable" and "used and useful" utilized by this Commission.

Staff's third adjustment decreased the Cascalbel exchange's accumulated depreciation by $9,195. This adjustment was based upon Staff's recalculation of depreciation expense at approved rates for all years since inception of the exchange.

The fourth adjustment reduced the Young exchange's accumulated depreciation by $215,025. This adjustment was based upon Staff's recalculation of depreciation expense at Qwest's approved rates for that exchange for all years since it was purchased from Qwest.

Staff's final adjustment increased accumulated deferred income taxes by $156,381. This amount of deferred income taxes are reflected in the general ledger of Midvale as attributable to Arizona operations.

ALLEN G. BUCKALEW

Mr. Buckalew was asked by the Staff of the Arizona Corporation Commission to provide an analysis of the rate design and separations issues in Midvale's applications for increases in rates. Mr. Buckalew's first task was to analyze whether Midvale Telephone Company complied with the FCC rules on separation found in Part 36 of the Code of Federal Regulations for Telecommunications. Part 36 of the Code outlines the procedures for the determination of the appropriate allocation of property costs, revenues, expenses, taxes, and reserves, as recorded on the company's books or to estimated values, to intrastate and interstate jurisdictions. The procedures are necessary because a characteristic of an integrated telecommunications system is that a large portion of total costs are common or joint in nature and therefore can be used for either intrastate or interstate services. After reviewing the studies for Part 36, Mr. Buckalew determined that Midvale Telephone Company complied with the rules and properly allocated telephone plant costs, revenues, expenses, and taxes to the Arizona jurisdiction. The Company's procedures are correct and consistent with the procedures found in the FCC rules.

The Company claimed a revenue deficiency of $108,955. The Company proposed to eliminate this deficiency by increasing the rates for residential and business customers in local service revenues by $61,210, and obtaining $147,567 from the Arizona Universal Service Fund. The Staff has revised the requested revenue requirement and after some adjustments in the rate base, accumulated depreciation, income-to-revenue multiplier, and exclusion of the EAS and unserved areas proposals, it has determined that an increase of $17,391 in revenues is needed. Mr. Buckalew's second task was to analyze Midvale's proposed rate design and to propose an alternative design if necessary. Mr. Buckalew determined that it was necessary to propose an alternative rate design.

Mr. Buckalew agrees with the Company's proposal to consolidate the rate structure under one rate design for all of its customers as far as possible. Mr. Buckalew's proposed business rate is $30 per month. In the area of residential rate design, Mr. Buckalew recommends no change in local rates for Cascabel residential customers and an increase to $17.15 for Young local exchange residential customers.

The Company proposes to include custom calling services in basic service. Mr. Buckalew disagrees; custom calling is not part of basic service and must have a separate price. Mr. Buckalew suggests a rate of $2.00 for the bundled group of custom calling services.
The Company also proposes to decrease access charge rates. Mr. Buckalew finds no reason to decrease access charge rates, especially for a Company with higher service area costs.

Mr. Buckalew recommends that the Company's request for extension of its CC&N into Millsite and Silver Bell be approved. Mr. Buckalew also recommends a basic local exchange rate of $24.00 for residential and $30.00 for business customers in Millsite and Silver Bell. After the facilities are built and customers are being served, the Company should apply for Federal high cost support and return to the Commission for a determination of the permanent local exchange rates and whether any AUSF is necessary.

SURREBUTTAL TESTIMONIES

DARRON W. CARLSON

The surrebuttal testimony of Staff witness, Darron W. Carlson, addresses the following issues in the rebuttal testimonies of the Company's witnesses:

Miscellaneous Interest Expense

Staff's application of the known and measurable standard and

Rate Case Expense.

Miscellaneous Interest Expense – Staff recommends excluding all interest expense from operating expenses because interest expense is a non-operating (below-the-line) expense. Pro forma interest expense relating to projected debt for funds to be used in the unserved areas is not known and measurable and should not be included in the calculation of the revenue requirement. Staff witness, Mr. Joel Reiker, is providing testimony regarding the effects of interest expense on the cost of capital.

Known and Measurable Standard – For purposes of determining the Company's revenue requirement in the rate case, pro forma adjustments should be limited to known and measurable changes to the historical test year amounts for revenues, expenses, and rate base. On the contrary, by necessity, rates for areas covered by a new Certificate of Convenience and Necessity ("CC&N") must be established based on projected information since no historical information exists.

Rate Case Expense – The Company has not refuted Staff's position that a major portion of the costs included in Company's claimed rate case expense are costs related to the CC&N extension that should be capitalized. The Company's proposed rate case expense is much greater than the amount the Commission typically recognizes for recovery in similar cases. Staff recommends that the Commission allow a more typical amount ($60,000 to be amortized over three years at $20,000 per year).

Staff continues to recommend the same intrastate operating revenue as reflected in Staff's direct testimony and schedules.

JOEL M. REIKER

The surrebuttal testimony of Staff witness, Joel M. Reiker, addresses the following issues in the rebuttal testimony of the Company's witness, Don C. Reading, Ph.D:

Miscellaneous Interest Expense – Staff rejects the Company's claim that an adjustment needs to be made to the capital structure if interest expense is excluded from operating expenses. The capital structure recommended by Staff already includes the appropriate amount of debt and interest expense.

Comparable Earnings Analysis – The comparable earnings analysis was not used to derive Staff's recommended cost of equity because the analysis produced results that were unreasonable, and a significant portion of the revenues of the comparable companies comes from competitive operations.

Capital Asset Pricing Model ("CAPM") – The beta reported by Value Line for the comparable companies reflects the entirety of their operations, which includes unregulated competitive sectors currently in the growth stage of the business life cycle.

Accordingly, Staff has adjusted the beta used in its CAPM calculation to more accurately reflect the risks associated with regulated operations.

Discounted Cash Flow ("DCF") Method – The basis of Staff's recommended 11.50 percent cost of equity recommendation is the DCF earnings growth result of 11.80 percent. The 11.80 percent was adjusted downward to account for the Company's equity-rich capital structure and the business make-up of the comparable companies.

Risk Adjustment – The Company's capital structure, cost of debt, and concentration in the local telephone industry contributes to a lower cost of equity than the comparable companies.

Unregulated Services – The rate of return set by the Commission should reflect the risk associated with the Company's regulated local telephone operations, not its unregulated subsidiaries.

Interpretation of Analyses – Staff's analyses and the analyses of the Company's witness both support Staff's recommended cost of equity of 11.50 percent.

Staff continues to recommend the same cost of capital as reflected in Staff's direct testimony and schedules.

SONN ALBRECHT

(NO SURREBUTTAL TESTIMONY FILED)

ALLEN G. BUCKALEW

Under the current Commission's rules, drawing from the AUSF is not allowed without plant in service and a cost study for the support area. I have suggested that the Company seek Federal high cost support to bring service to Millsite and Silver Bell. I have proposed an initial exchange rate of $24.00 per month for customers in these unserved areas. This rate was developed based on Midvale's current revenue experience and its estimated cost of serving these new customers. My analysis has assumed that the Company received less support per line from the Federal USF than it currently does. In calculating my hypothetical initial rate of $24.00 per month for the 278 expected customers, I included an annual support in the amount of $71,651. This amount, which represents one-half the current level of Interstate USF revenue, more than likely understates future revenues.